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Q3 2006

VENTURE CAPITAL MONITOR

A QUARTERLY UPDATE ON THE CANADIAN VENTURE CAPITAL INDUSTRY

The Canadian venture capital (VC) industry is a key contributor to the growth of innovative firms that commercialize research. For this reason, the health of this industry is an ongoing concern. The goal of this series is to provide current information about this key enabling industry. To this end, the series will track trends in investment activity, report on topical VC-related research and look at key technology clusters where VC investment is taking place.

INTRODUCTION

This issue, in addition to reporting on Canada's VC trends for the third quarter of 2006,¹ examines VC syndication and its impact on firms receiving such investment. This quarter's "In Focus" article will look at VC in the Ottawa area, where there has been a sharp decline in the number of new companies that have received VC — the focus instead being placed on "follow-on" investment in firms that have already received financing.

VC ACTIVITY OVERVIEW

Investment and fundraising²

VC investment during the third quarter of 2006 increased 13 percent over the same period in 2005, rising to \$330M from \$291M. However, overall activity for the year to date is down 9 percent from last year, falling to \$1.19B from \$1.3B. If this trend continues through the fourth quarter, VC investments will decline for the second consecutive year.

Fundraising in the third quarter of 2006 totalled \$330M, up from \$229M in the same quarter last year. Total year-to-date fundraising is \$1.21B, down from \$1.43B last year (Table 1).

The declining trend of fundraising is a concern as it suggests a decline in future domestic investment as funds raised today are the basis for investment in subsequent years.

Table 1
VC investments and fundraising in the first three quarters of 2005 and 2006

	2005	2006	Growth Rate
	Q1+Q2+Q3	Q1+Q2+Q3	
	(\$ millions)		(percent)
Investments	1300	1190	-9
Fundraising	1430	1210	-15

Source: Thomson Financial Canada 2006.

Average deal size³

For the 122 deals that occurred in Q3 of 2006, the average deal size was \$2.70M (Table 2), down 29 percent from the \$3.80M observed in Q2 of 2006, but up 56 percent from Q3 of last year. Foreign investors have a significant impact on deal size. When foreign investors' deals are excluded, the average deal size in Q3 of 2006 was \$2.26M, up 52 percent from Q3 of last year. In contrast, the average deal size for foreign investors was \$5.63M in Q3 of 2006, down slightly from \$6.05M in Q3 of 2005.

¹The data source for this publication is Thomson Financial Canada, unless otherwise stated.

²**Fundraising** refers to the activity by which VC funds receive money from institutional investors, individuals, governments and others. **Investment** refers to the activity by which VC funds invest those monies on behalf of their investors.

³A **deal** refers to the transaction between one or more VC funds and the firm receiving the funding (portfolio firm). Larger average deal sizes suggest that firms are better financed for achieving growth.

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Table 2
Average deal size, domestic versus foreign investors

	Q3 2005	Q3 2006
	(\$ millions)	
Foreign Investors	6.05	5.63
Domestic Investors	1.49	2.26
All	1.73	2.70

Source: Thomson Financial Canada 2006.

For the year to date, the average deal size was \$3.1M, up 34 percent from \$2.3M during the same period last year, and consistent with the historical annual average deal size.

Increasing share of follow-on and later-stage investment

In the first three quarters of 2006, follow-on⁴ investment accounted for more than 80 percent of total investment, with an average deal size of close to \$5M. New portfolio companies⁵ received the remaining 20 percent with an average deal size of \$1.8M. The proportion of investment in new companies is much lower than its historical level of 40 percent. This pattern often occurs when fundraising is constrained as VC funds conserve resources needed to support the growth of their existing portfolio firms. Table 3 provides a breakdown of new and follow-on investment by stage.⁶ It is noteworthy that 71 percent of follow-on investments were in later-stage companies, well above the 10-year historical average of 55 percent.

All foreign investment in Q3 of 2006 was in follow-on deals, with 96 percent allocated to the expansion stage, which is in line with historical trends.

Table 3
New and follow-on investment distribution between early-stage and later-stage companies

		Q3 2005	Q3 2006
		(percent)	
New	Early Stages	40	62
	Later Stages	60	38
Follow-on	Early Stages	43	29
	Later Stages	57	71

Source: Thomson Financial Canada 2006.

Regional focus

Ontario and Quebec accounted for 40 percent and 32 percent of total VC investment, respectively, during the third quarter of 2006. The main source of investment in Ontario was foreign VC, whereas investment in Quebec was led by Labour Sponsored Venture Capital Corporations (LSVCCs).⁷ Figure 1 shows each region's share of year-to-date VC investment in comparison to gross domestic product (GDP) and the number of firms in knowledge-based industries (KBIs). The distribution of VC investment so far this year is consistent with the historical average. The proportion of VC investment is roughly equal to the proportion of KBI firms except in Quebec, where it is much higher, and in the Prairies, where it is much lower. The discrepancy in the Prairies may be caused by VC activity in Alberta being under-reported. Atlantic Canada represents only 2 percent of VC investment and 3 percent of KBIs while representing 6 percent and 7 percent of Canada's GDP and population, respectively. All of that region's investments were in Nova Scotia, where the two main investors are government and LSVCCs. Foreign and private independent investors have a weak presence in Atlantic Canada.

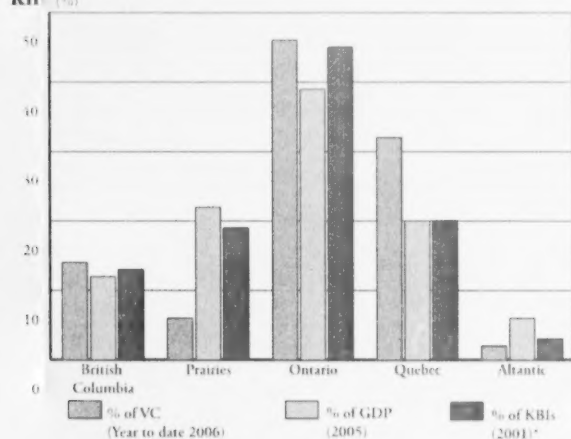
⁴ **Follow-on VC** refers to financing of companies that have already received VC.

⁵ **New portfolio companies** refers to firms that have not received prior VC financing.

⁶ **Late-stage firms** refers to established companies that need capital to expand. **Early-stage firms** refers to developing businesses that need funding for research, product development or initial marketing.

⁷ **LSVCCs** are special VC firms that receive their funds from individuals who in turn receive an income tax credit for their investment. The federal government and most provincial governments have LSVCC programs.

Figure 1
Regional distribution of VC investment,
Knowledge-based industry firms and GDP
known (%)



Source: Thomson Financial Canada 2006, Statistics Canada 2006.
Source: Industry Canada 2003.
Industry recent data available.

* Market share of foreign VC rises as LSVCC share of investment declines

Over the last decade, the Canadian VC market has seen increasing activity led by foreign investors. In the third quarter of 2006, they represented 27 percent of the investments, and they have accounted for a third of VC investments so far this year, surpassing the historical average of 25 percent. Participation in VC investment by LSVCCs is reported to be about 20 percent, which is below the historical average of 28 percent.

Government activities⁸

On the third quarter of 2006, the Business Development Bank of Canada (BDC) authorized VC investments worth a total of \$26.8M in 20 companies. In November, the BDC launched GO Capital, a co-investment fund that will provide \$50M for business innovation and start-up in Quebec's technology sector. The BDC will act as the fund's manager and will invest \$10M in the fund along with four Quebec-based funds. It will also match the fund's investments, bringing the available capital to \$100M. Export Development Canada (EDC) provides equity investments in Canadian SMEs to expand their export

operations. It also invests in foreign projects that involve Canadian goods and services. EDC did not report any VC deals in the third quarter of 2006.

Canada Economic Development for Quebec Regions has launched "The Venture Capital Fund for Business Start-ups." It has committed \$5M and will raise more than \$15M from other VC firms and entrepreneurs.

Provincial government funds were behind six deals in the third quarter. These funds invested alone, as lead investors with other partners or alongside the BDC. The largest deal led by these funds was a \$4M investment in Medusa Medical Technologies. This was led by Nova Scotia First Fund and backed by VC funds based in the U.S. and the U.K.

SYNDICATION AND THE COST OF VC

"Syndication" is a prevalent phenomenon in Canada's VC landscape. Since 1999, half of the VC deals in Canada have been made in syndication and the trend is on the rise. Syndicated deals account for about 80 percent of VC funds invested. Syndication of angel investors in Canada is also on the rise. Research indicates that investors syndicate to share risk, expertise and skills, or in cases where single investors do not have sufficient funds on their own.

A recent study¹⁰ on the costs of VC financing suggests that deals made in syndication may impose greater costs on the portfolio firm, especially when each round of financing involves new syndicate members. These costs include longer negotiation periods and repetition of due diligence activities when new investors join the syndicate during follow-on rounds. The study indicates that syndication may make the VC market less competitive by reducing the number of alternative VC funds that a technology firm can approach for funding. It suggested that this may negatively affect the firm's negotiating power and therefore its valuation.

A crucial effect of a less competitive VC market is that technology firms may be forced to accept deals that do not provide enough capital to grow the firm, reducing its potential for success.

⁸ Future editions of *Venture Capital Monitor* will include details on VC deals by the BDC, EDC and Farm Credit Canada's FCC Ventures.

⁹ **Syndication** refers to more than one VC firm participating in the same financing deal with a portfolio company.

¹⁰ Sylvie Carpentier and Jean-Marc Suret, July 2006; Cécile Carpentier and Jean-Marc Suret, June 2005.

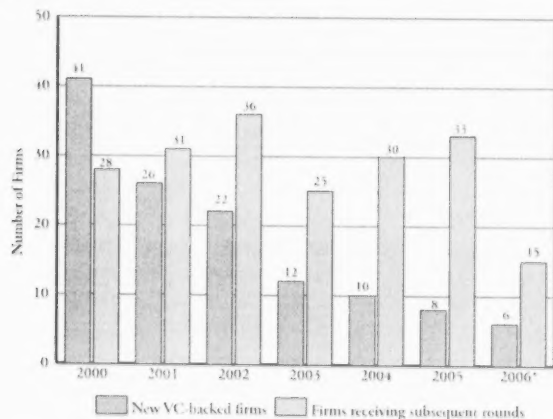
The aforementioned research has only scratched the surface of the issues related to how syndication impacts the firm.

"IN FOCUS" — OTTAWA-CARLETON

Between 1999 and 2006, there were 169 VC-backed technology firms in Ottawa, of which more than 80 percent were in the IT sector. The predominance of the IT sector, particularly telecommunications and networking, is mainly due to the presence in the late nineties of world-class public research centres and communications and networking giants such as Nortel, JDS Uniphase, Mitel, MOSAID and Tundra.¹¹ Outsourcing by these companies and spinoffs created by ex-employees of these giants nurtured the current cluster of technology companies.

Today, five years after the tech-bubble, Ottawa has seen some recovery, but progress is slow. The IT and communication sectors continue to dominate, which continues to make the technology cluster vulnerable to cyclical shocks in this sector.

Figure 2
Number of Ottawa firms receiving first-round VC versus number of firms receiving follow-on VC, 2000–2006



Source: Thomson Financial Canada 2006.

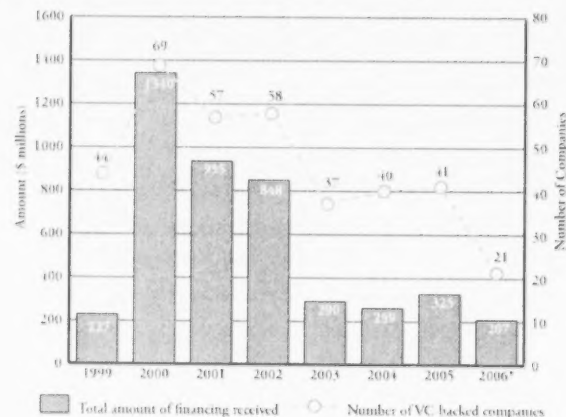
* Only data for the first three quarters of 2006 are included. The number of new companies might be underestimated given that Thomson Financial does not disclose information on certain deals.

¹¹ Jocelyn Mallett, 2002.

Figure 2 shows that, consistent with national trends mentioned above, VC investment in Ottawa is focused on firms that have previously received VC. The number of Ottawa-based technology firms receiving their first round of VC has sharply declined since its peak of 41 companies during the "technology bubble" in 2000 to only eight new companies in 2005. With six new companies receiving VC financing during the first three quarters of 2006, it is likely that the total number of new VC-backed companies this year will be similar to 2005.

The total number of companies receiving VC dropped after the technology bubble, but recovered in 2004 and 2005 with 40 and 41 companies being financed respectively (Figure 3).

Figure 3
VC investment in Ottawa, 1999–2006



Source: Thomson Financial Canada 2006.

* Only data for the first three quarters of 2006 are included.

The Ottawa Centre for Research and Innovation's (OCRI's) Entrepreneurship Centre notes that although there are many start-ups in Ottawa with solid potential, they often find it difficult to secure VC. This is consistent with OCRI's 2005 report, which states that Ottawa entrepreneurs are increasingly funding their firms using their own resources instead of relying on VC investment. OCRI also notes that the focus on existing portfolio companies is part of a natural investment cycle. VC firms that began funding new portfolio companies during the tech-bubble are bringing their companies

toward exit. Once they realize their investments, they will start again with new companies. Moreover, positive developments include plans by VC firm Ventures West to open an office in Ottawa, and formation of the Ottawa Angel Alliance. These developments will likely lead to increased VC investment in the city.

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NOTES

This publication is part of a series prepared by the Small Business Policy Branch. The branch analyses the financial marketplace and how trends in this market impact small businesses' access to financing. Current research is focused on high-growth firms, the aspects of both Canada's VC and general business environment that affect the success of these firms, and the key players in the risk-capital market (for example, VC firms and angels). The Small Business Policy Branch is also responsible for the Small and Medium-Sized Enterprise Financing Data Initiative (SME FDI). The SME FDI is a comprehensive data-collection program on SME

financing in Canada. In partnership with Statistics Canada and Finance Canada, Industry Canada reports on the supply of, and demand for, small and medium-sized business financing to provide a complete picture of SME financing. Further information and statistical findings and reports are available at www.sme-fdi.gc.ca.

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